

## PUBLIC UTILITIES COMMISSION

505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3298



May 20, 2003

Agenda ID #2266

TO: PARTIES OF RECORD IN RULEMAKING 01-12-009

This is the draft decision of Commissioner Brown. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the draft decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the draft decision as provided in Article 19 of the Commission's "Rules of Practice and Procedure." These rules are accessible on the Commission's website at <http://www.cpuc.ca.gov>. Pursuant to Rule 77.3 opening comments shall not exceed 15 pages. Finally, comments must be served separately on the ALJ and the assigned Commissioner, and for that purpose I suggest hand delivery, overnight mail, or other expeditious method of service.

/s/ ANGELA K. MINKIN  
Angela K. Minkin, Chief  
Administrative Law Judge

ANG:tcg

Attachment

Decision **DRAFT DECISION OF COMMISSIONER BROWN** (Mailed 5/20/2003)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the  
Commission's Own Motion to Evaluate Existing  
Practices and Policies for Processing Offset Rate  
Increases and Balancing Accounts in the Water  
Industry to Decide Whether New Processes are  
Needed.

Rulemaking 01-12-009  
(Filed December 11, 2001)

**FINAL DECISION REVISING THE PROCEDURES FOR RECOVERY OF  
BALANCING ACCOUNTS EXISTING ON OR AFTER NOVEMBER 29, 2001**

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**FINAL DECISION REVISING THE PROCEDURES FOR RECOVERY OF  
BALANCING ACCOUNTS EXISTING ON OR AFTER NOVEMBER 29, 2001****I. Summary**

In this decision, we revise the existing procedures for recovery of under collections and over collections in balancing accounts existing on or after November 29, 2001 as follows: (1) If a utility is within its rate case cycle and is not over earning, the utility shall recover its balancing account subject to reasonableness review; and (2) If a utility is either within or outside of its rate case cycle and is over earning, the utility's recovery of expenses from the balancing accounts will be reduced by the amount of the over earning, again subject to reasonableness review. The utility shall remove the amount of the over earning from the balancing account and shall amortize it below the line. Utilities shall use the recorded rate of return means test to evaluate earnings for all years.

**II. The Order Instituting Rulemaking****A. Pub. Util. Code § 792.5**

The Commission may permit a utility to change its rates to account for a change in costs (sometimes called an offsettable expense change, or an offset.) Upon receiving authorization to pass through the costs, the utility shall maintain a balancing account under Pub. Util. Code § 792.5,<sup>1</sup> reflecting the difference between actual costs the utility incurs and the revenue collected through the

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<sup>1</sup> Pub. Util. Code § 792.5 speaks in terms of a "reserve account." (See the text of the statute in the footnote below.) A reserve account that has both revenues and expenses booked to it is also called a balancing account.

expense offset rate increase or decrease.<sup>2</sup> The Commission has traditionally authorized offset rate increases and attendant balancing account treatment to protect utilities from significant unforeseen expenses over which the utility has no control, such as the unforeseen increased expenses of purchased power, purchased water and pump tax. When the Commission approves a new water or sewer system utility, or when a regulated water or sewer company buys a non-regulated system, there is no balancing account protection for those systems until the utility requests an offset.<sup>3</sup>

### **B. The Controversy**

In the summer of 2001, several water utilities filed advice letters seeking offset rate increases to compensate for recent increases in the costs of purchased power that were not anticipated in the utilities' last general rate case. The Office of Ratepayer Advocates (ORA) protested the request to raise the rates of 20 districts of California Water Service Company (CWS), arguing that: (1) the Commission should not authorize offset rate increases for CWS districts because the utility was "over earning," that is, it was earning a rate of return greater than

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<sup>2</sup> Pub. Util. Code § 792.5 states: "Whenever the commission authorizes any change in rates reflecting and passing through to customers specific changes in costs, except rates set for common carriers, the commission shall require as a condition of such order that the public utility establish and maintain a reserve account reflecting the balance, whether positive or negative, between the related costs and revenues, and the commission shall take into account by appropriate adjustment or other action any positive or negative balance remaining in any such reserve account at the time of any subsequent rate adjustment."

<sup>3</sup> Attachment 9 of the 1983 "PROCEEDURES FOR MAINTAINING BALANCING ACCOUNTS FOR WATER UTILITIES" restricts offsets to "a minimum of 1% of gross revenues" (last sentence in the Introduction) further limiting balancing account protection.

that authorized in the utility's last general rate case; and (2) the Commission should not permit water districts that are outside their rate case cycle to utilize balancing account treatment.<sup>4</sup>

In response, the Commission's Water Division drafted Resolution W-4294, dated November 29, 2001, which researches the history, rationale, and procedures for implementing offset rate relief and related balancing accounts. The Water Division staff concluded that: (1) ORA's protest raises serious issues of first impression warranting full Commission consideration; and (2) the Commission should consider ORA's recommendations on an industry-wide basis. The Commission agreed with staff's recommendations and issued this Order Instituting Rulemaking (OIR).

### **C. The OIR and the Interim Decision**

In the OIR, we evaluate existing practices and policies for processing offset rate increases and balancing accounts for water utilities and determine if new procedures or policies are needed. The OIR identifies Class A and B water and sewer system utilities and ORA as respondents for written inquiries, and states that other interested parties and other water and sewer system utilities are not required to, but can, participate.

The OIR stated that the issue of what balancing account procedures should apply to balancing accounts existing prior to November 29, 2001 (the date Resolution W-4294 issued) should be resolved in an interim decision, and the

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<sup>4</sup> According to ORA, districts that failed to apply for a general rate case when they had an opportunity to do so, either according to the Rate Case Plan adopted in Decision (D.) 90-08-045, 37 CPUC2d 175, or by other Commission decision, would be outside of their rate case cycle.

issue of whether the Commission should revise the balancing account procedures prospectively should be reserved for a final decision. In its interim decision, Decision (D.) 02-12-055, the Commission retained the existing balancing account procedures for processing accounts existing prior to November 29, 2001. The Commission reasoned that because many water utilities may have planned their operations based on the existing rules that have been operative for over 20 years, it would be inequitable to apply new rules for balancing accounts existing prior to November 29. The Commission reserved the issue of whether the rules should change prospectively (i.e., on or after November 29) for a final decision.

The OIR also determined the following issues were appropriate to address in this proceeding:

“Should the Commission revise its existing rules for obtaining offset rate increases to include consideration of (A) whether the district/utility is outside its rate case cycle? (B) whether the district/utility is over earning on an actual basis? (C) whether the district/utility is over earning on a weather adjusted pro-forma basis?

“Should an earnings test be employed to determine whether a district/utility should be allowed to recover all, none, or some portion of under collections in a balancing account? If so, should the test be weather adjusted or actual recorded earnings?

“Should offset rate increases and attendant balancing account treatment be available only to the district/utility that has subjected itself to the scrutiny of a GRC and is currently in that rate case cycle?

“If a district/utility outside its last rate case cycle is eligible for offset rate increases and attendant balancing account treatment, what calculation should be used to replace the state adopted quantities from the last GRC?” (OIR at p. 5.)

### **III. Procedural Background**

D.02-12-055 addressed much of this rulemaking's procedural background and affirmed rulings as to scope, which we incorporate by reference here.

The OIR set forth a number of questions relevant to the issue of whether the balancing account procedures should be revised on a going-forward basis. We received responses or replies from ORA as well as the following utilities: Alco Water Service, Apple Valley Ranchos Water Company, California-American Water Company (CalAm), CWS, East Pasadena Water Company, Fruitridge Vista Water Company, Great Oaks Water Company (Great Oaks), Park Water Company, San Gabriel Valley Water Company (San Gabriel), San Jose Water Company, Southern California Water Company (SCWC), Suburban Water Systems and Valencia Water Company.

The California Water Association, Great Oaks, and SCWC requested oral argument pursuant to Rule 8(d) of the Commission's Rules of Practice and Procedure. The Commission held oral argument on September 20, 2002, on all issues in this rulemaking.

### **IV. Resolution W-4294**

Before reaching its determination that the Commission should institute this OIR, Resolution W-4294 presented a detailed and useful background of the history of balancing accounts, within and outside the water industry, which we summarize here.

#### **A. Balancing Accounts Outside the Water Industry: The Edison Case**

Because of the steep increase in fuel prices in the early 1970s, the Commission authorized ratemaking adjustment mechanisms to protect utilities from the financial impact of substantial unforeseen expenses beyond the utilities' management and control. One such mechanism, the fuel cost adjustment clause



(fuel clause), provided utilities with an expedited method (outside of frequent general rate cases) to recover expenses related to rapid changes in fossil fuel costs, to ensure continued utility operations, and to enhance their position in the financial community.

By 1975, it became clear that the fuel clause was producing distorted results. Instead of reimbursing the utilities for their actual fuel costs, the clause produced a windfall for the utilities that bore no relation to actual expenses. For example, between May 1972 and December 1974, Southern California Edison Company (Edison) repeatedly invoked the clause and raised rates no less than 12 times. In 1974, Edison had accumulated an over collection of \$122.5 million, representing 56% of Edison's system-wide net income. In response to this problem, the Commission modified the fuel clause to insure that utilities did not reap this unanticipated windfall at ratepayers' expense. The modification was a balancing account entitled the energy cost adjustment clause (ECAC). The Commission also required Edison to return to ratepayers by a billing credit the substantial over collections that the fuel clause generated.

In the Edison case,<sup>5</sup> the California Supreme Court upheld the Commission's decision refunding the over collections and establishing the ECAC, explaining that the Commission effectively corrected the distorted results of the old fuel clause by relying on actual fuel expenses from all sources incurred during a prior period rather than a forecast. The utility was required to maintain a monthly balancing account into which it would enter the amount by which its actual energy cost for the month was greater or less than the revenue generated

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<sup>5</sup> Southern California Edison Company v. Public Utilities Commission (1978) 20 Cal.3d 813.

by the clause, and on each occasion the clause was invoked, the billing factor would be adjusted so as to bring the balance of the account to zero.

Edison argued that it was entitled to keep the large over collections generated by the old fuel clause because its actual rate of return averaged less than that authorized by the Commission. The Court disagreed, explaining that the utility is entitled only to the opportunity to earn a reasonable return on its investment, and that the law does not ensure it will in fact earn the authorized rate of return, or any net revenues. (Edison case, 20 Cal.3d at 821, n. 8.)

The Supreme Court also rejected Edison's argument that the Commission action was prohibited because it subjected Edison to retroactive ratemaking, explaining that the charges arising from the fuel clause were not the product of general ratemaking:

“Because the increased charges thus imposed were not the products of ratemaking, they were not rendered inviolable by the rule against *retroactive* ratemaking. To put it another way, the commission's decision to further adjust those rates so as to compensate for substantial past overcollections may well be retroactive in effect, but it is not retroactive *ratemaking*.” (Edison case, 20 Cal.3d at 830.) (Emphasis in the original.)

Finally, Edison argued that the Commission's abrupt change from the old fuel clause's average-year forecast method to the ECAC recorded method unreasonably disrupted the weather normalized process by which the old clause, given enough time, would have balanced over and under collections. The Court noted that Edison therefore had no expectation of benefiting financially from the fuel clause, and should not be disadvantaged by the requirement to return over collections to customers over a three-year period.

## **B. The Operation of Water Balancing Accounts**

Applying an earnings test to balancing accounts is not new. The Commission allowed offsets for purchased water and power expense changes for Class A water utilities as early as 1974,<sup>6</sup> and for pump tax as early as 1972.<sup>7</sup> The advice letter offsets filed in the 1970s ranged from purchased power, purchased water and pump taxes, to employee labor and benefits and ad valorem and franchise taxes. Utilities filed 17 such offsets between 1972 and 1977. In each case, the increase was subject to an earnings test.<sup>8</sup>

In 1977, the Commission first established rules to address changes in water utilities' offsettable expenses. The 1977 policy described the advice letter offset program for purchased power, purchased water, and pump taxes as similar in concept to the ECAC in that the offset program allows a utility to recover cost increases that are generally beyond their immediate control. This policy required that in order to be eligible for the offset, the utility's rate of return should not exceed that last authorized by the Commission, and the amount of the offset should not exceed the revenue increase.<sup>9</sup>

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<sup>6</sup> See Resolution W-1550, April 30, 1974, Southern California Water Company Advice Letter 432-W to offset changes in purchased power (electricity and natural gas).

<sup>7</sup> See Commission memorandum dated May 24, 1972 regarding California Water Service Company Advice Letter 390 to offset changes in pump tax.

<sup>8</sup> The language of the resolutions does not indicate whether this was a recorded or a pro-forma earnings test. In either case, since there was no over earning under either test, no disallowances were required.

<sup>9</sup> Memorandum to the Commission from B.A. Davis, Director, Operation Division, Subject: Major Water Utilities Regulatory Policy, dated June 21, 1977, at p. 1, approved at the June 28, 1977 Commission conference.

In 1978, the Commission approved procedures for maintaining balancing accounts.<sup>10</sup> The 1978 procedures did not include a test to determine if the requested offset would cause the utility to exceed its authorized rate of return. However, for the past several years, Commission staff has continued to apply a weather normalized (pro forma) earnings test to determine if the requested offset will cause the utility to exceed its authorized rate of return.<sup>11</sup> When staff identifies such over earning, they delay but do not deny the requested offset rate increase or recovery of the balancing account until the earnings test demonstrates the utility would no longer be over earning.

The 1978 balancing account policy for Class A and B water and sewer utilities required that multi-district utilities maintain separate balancing accounts for each district and that each district keep three separate balancing accounts for (1) water production cost offsets, including purchased water and purchased power; (2) ad valorem tax offsets; and (3) all other types of offsets. The balancing account balances were to be amortized at the time of a general rate case; however, the availability of balancing accounts to record the over and under collection of offsettable expenses is continuous. For the most part, the 1978 policies are in place today.

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<sup>10</sup> Procedure for Maintenance of Balancing Accounts for Water Utilities, approved on June 6, 1978.

<sup>11</sup> The weather normalized (pro forma) earnings test calculates the rate of return by using (1) the revenues calculated by adding the actual commercial sales and actual number of residential customers times the already weather normalized number of sales per customer adopted in the last general rate case, minus (2) the expenses authorized in the last general rate case adjusted by the actual number of customers and any approved offsets.

The Commission revised the balancing account procedures in 1983, and clarified that water and sewer utilities should record only the incremental change in cost increases incurred and revenues received since the utility's general rate case or last offset rate increase. The 1983 revisions also expressed concern about the use of quantities adopted in a general rate case when the rate case decision is older than five years, stating that these requests would be handled on a case-by-case basis.

In 1994, the Commission issued D.94-06-033, 55 CPUC2d 158 in its investigation into the financial and operational risks of regulated water utilities (the Risk OII). This decision addressed some balancing account issues for Class A water utilities specifically water quality expenses. The decision considered but rejected a utility proposal for a program of complete expense protection using a broad memorandum account, reasoning that the majority of water quality costs could be forecast with reasonable accuracy and included in a general rate case application. However, it permitted water utilities to seek authority in a general rate case or by application to add other specific water quality expenses to the Water Quality Memorandum Account, provided the costs were

“unforeseen and therefore were not included in the utility's last general rate case, that the costs will be incurred prior to the utility's next scheduled rate case (or otherwise cannot be estimated accurately for inclusion in a current rate case), and that the expenses are beyond the control of the utility.”  
(55 CPUC2d at 191.)

### **C. The Rate Case Plan for Water Utilities**

In 1990, the Commission adopted a rate case plan for Class A water utilities. (See D.90-08-045, 37 CPUC2d 175.) Under the rate case plan, each utility is allocated a time for filing its general rate case, generally once every three years either in January or July. The rate case plan for water utilities, like a

similar plan for energy utilities, establishes a comprehensive schedule for processing a general rate case, but does not require water utilities to file regularly for general rate cases.

#### **D. Pub. Util. Code § 455.2**

Pub. Util. Code § 455.2 became effective on January 1, 2003. Section 455.2(c) requires the Commission to establish a schedule to require every water corporation subject to the water rate case plan to file an application pursuant to the plan every three years. Pursuant to § 455.2(c), “the plan shall include a provision to allow the filing requirement to be waived upon mutual agreement of the Commission and the water corporation.”

#### **V. Should the Commission Revise Existing Procedures for Recovery of Under Collections and Over Collections in Balancing Accounts Existing on or After November 29, 2001?**

##### **A. Parties’ Positions**

The OIR presented 23 questions for response. We combine the major topics in this summary of the parties’ positions.

##### **1. What Expenses are Offsettable?**

The utilities and ORA agree that purchased power, purchased water and pump tax should be offsettable expenses because increases in these expenses are difficult to predict and are beyond the utilities’ control. Furthermore, these expenses make up a large portion of a utility’s total expenses, so increases have the potential to have a large impact on earnings.

Many utilities suggest that some other expenses (such as postage costs, property taxes, water testing, etc.) should also be offsettable because they

are uncontrollable. ORA disagrees because these types of expenses are generally more predictable and do not have a significant effect on utility earnings.

**2. Is a Balancing Account, or a Memorandum Account, the Proper Way to Track Offsettable Expenses?**

Most of the parties, including ORA, believe that a balancing account is the proper vehicle by which to track offsettable expenses, and in fact, is the type of account the Legislature was referencing in Pub. Util. Code § 792.5. The utilities distinguish between recovery of balancing accounts and memorandum accounts, believing that memorandum accounts are subject to reasonableness review whereas balancing accounts are not. ORA disagrees, and believes that the Commission may review and disallow recovery of balancing accounts as well.

**3. Should There be an Earnings Test on Balancing Account Recovery?**

All but one of the utilities oppose an earnings test on balancing account recovery. Some utilities believe that an earnings test reduces or eliminates a utility's incentive to operate efficiently. San Gabriel explains that the incentive for a utility to improve efficiencies is that it is allowed to keep the additional revenues until the next rate case, when these savings are passed on to the ratepayers. San Gabriel believes that subjecting offsettable expenses to an earnings test would pass these revenues immediately to ratepayers. CWS believes that applying an earnings test to balancing accounts would create a perverse incentive to increase rates.

If the Commission implemented an earnings test, Cal-Am believes it would be acceptable if companies were allowed to file regularly and for small amounts. Cal-Am believes the test should be based on the utilities' annualized controllable expenses, and that offset expenses and revenues should not be

considered. Cal-Am believes that actual recorded expenses should be used for the test.

ORA believes there should be an earnings test because the purpose of the offset accounts is to ensure against threats to the utilities' earnings. Thus, ORA argues that an earnings test is essential to determine if there is a genuine threat to utilities' earnings. ORA also argues that an earnings test is essential to preclude windfall earnings.

Many utilities believe that if the Commission requires an earnings test, it should be a pro forma test because this test uses the same weather normalized production estimates used to determine the utility's rates in a general rate case. Great Oaks believes that if new procedures are adopted, the procedures should allow a recorded earnings test to be used, since Great Oaks is in the position of over earning on a pro forma basis but not on a recorded earnings basis. ORA believes that a recorded earnings test is more appropriate since offset accounts are designed to recover actual expenses.

Many utilities suggest that if the Commission implements an earnings test, the test should, at most, delay the offset rate increase until the utility is no longer over earning. However, several utilities believe that this delay would create an intergenerational inequity among ratepayers. ORA believes that if a utility fails the earnings test it has no need of balancing account protection, and that the balancing account should be returned to zero.

## **B. Discussion**

### **1. Policy Reasons Underlying the Need to Revise Our Procedures**

Like the Edison case, we believe that a revision to our existing procedures is necessary here in order to effectively correct distorted results. The



existing procedures for recovery of under and over collections in balancing accounts, which we suspended as of November 29, 2001, were originally established for the utilities to recover unanticipated increases in electricity costs<sup>12</sup> between general rate cases, without the need to file an additional rate case application. The procedures also served the purpose of protecting shareholders from having to finance large unanticipated expenses until the next general rate case.

These procedures served, in effect, as insurance to protect a utility against its failure to earn its authorized earnings due to unanticipated expenses beyond the utility's control. When a person obtains insurance, the insurance is paid or invoked when the event insured against occurs. Similarly, offset balancing account recovery should only occur when the utility fails to earn up to its authorized rate of return due to unanticipated expenses beyond its control and that are the subject of the balancing account. To the extent a utility is earning above its authorized rate of return, recovery of the balancing account should be reduced by the amount of over earning since the event insured against (i.e., the failure to earn its authorized earnings) has not occurred.

Thus, the existing procedures become problematic when they have the effect of enhancing utilities' earnings above the Commission-authorized rates of return. It is unreasonable and unnecessary to permit the utilities to pass through to ratepayers the dollar-for-dollar costs accumulated in their balancing accounts when these same utilities are earning more than their authorized rate of return, particularly when their ratepayers are also experiencing the same

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<sup>12</sup> The Commission expanded this balancing account mechanism to include two additional types of unanticipated expenses: pump taxes and water acquisition expenses.

increased electrical costs in their own homes. To permit such recovery would be to grant the utilities an unanticipated windfall at ratepayer expense.

Another related problem with the existing balancing account procedures occurs when a utility fails to file general rate case applications every three years, yet continues to seek balancing account treatment beyond the rate case cycle, thus depriving the Commission of scrutiny over the assumptions used to determine the rate structure. When these assumptions become stale, the rate structure becomes skewed. While we anticipate this problem will be addressed by Pub. Util. Code § 455.2(c) requiring water utilities subject to the rate case plan to file rate cases every three years, that section permits the three-year filing requirement to be waived upon mutual agreement by the Commission and the water utility.

The Edison case is consistent with today's decision to revise the balancing account procedures for accounts existing on or after November 29, 2001. In the Edison case, the California Supreme Court permitted the Commission to change the procedures for recovery of the fuel clause when the existing procedures produced distorted results and an unanticipated windfall for Edison. The Court so held, even though the Commission did not modify the fuel clause on a prospective basis only, but required Edison to amortize, by 36 months of billing credit to its customers, the substantial over collections generated by operation of the fuel clause. Here, we do not require that the utilities refund any amounts to customers; we merely revise the existing procedures on a prospective basis (after the Commission gave notice that these revisions may occur in Resolution W-4292) so that customers do not finance utility revenues in excess of the utility's authorized rate of return for balancing account expenses.

## **2. Responses to the Utilities' Objections**

The utilities argue that capping their recovery of the balancing accounts so that a utility can achieve, but not exceed, its last authorized rate of return is unreasonable or illegal for a number of reasons. The utilities argue that this proposal: (1) is unfairly “one-sided”; (2) increases utility risk; (3) violates the regulatory compact; (4) denies the utility the right to earn a fair return on investment; (5) constitutes retroactive ratemaking; (6) does not comply with Pub. Util. Code § 792.5; and (7) reverses an earlier Commission decision that did not require the water utilities to file general rate cases every three years. After the enactment of Pub. Util. Code § 455.2, the utilities also argue that this recent statute solves the problems the OII has raised and thus, no changes to the balancing account procedure are necessary. We disagree, as we explain below.

The proposal is not unfairly “one-sided” as claimed. The original purpose of these balancing accounts was to allow the utilities to recover unanticipated expenses within the normal rate case cycle to prevent financial injury, and, as discussed above, to serve as insurance to utilities that certain uncontrollable expenses would not affect their ability to achieve authorized earnings. A utility that exceeds its authorized rate of return is not in financial peril; thus, there is no need for recovery of the balancing account amounts in excess of its authorized rate of return.

The utilities also argue that capping recovery of the balancing accounts can increase risk. The issue of how various risks affect a utility's rate of return involves an inquiry into all relevant circumstances, not just one specific factor. D.02-12-055 affirmed the scoping memo in noting that the readjustment of a utility's specific rate of return is not within the scope of this industry-wide proceeding. The appropriate forum for such a utility-specific inquiry is a utility's

general rate case or other appropriate proceeding the Commission may designate in the future.

We disagree with the utilities that the revised procedure violates the regulatory compact because the monies were booked pursuant to a longstanding procedure with an expectation of recovery pursuant to this procedure. We note, first, that one utility, CalAm, believed the “longstanding procedure” capped recovery at the utility’s authorized rate of return, and operated its balancing accounts accordingly. Second, and more fundamental, as shown by the Edison case discussed above, the Commission has the discretion to modify the existing procedure when it is producing unintended results.

The proposal will not deny the utility a right to earn a fair rate of return on investment. In the Edison case, the California Supreme Court upheld the Commission’s modification of the fuel cost adjustment clause although Edison’s actual rate of return averaged less than that authorized by the Commission. Here, the revised procedures will permit the utility to earn at least up to its authorized rate of return, and even more than the authorized rate of return through any means other than the collection of these balancing accounts.

We disagree that the revised procedures constitute retroactive ratemaking. In the Edison case, the Supreme Court rejected Edison’s argument that the Commission action modifying the fuel clause constituted retroactive ratemaking, reasoning that the increased charges imposed were not the product of ratemaking. (20 Cal.3d at 830.) The Court further held that the prohibition of retroactive ratemaking should not be used as a device to “fetter the commission in the exercise of its lawful discretion.” (20 Cal.3d at 816.)

“...[W]e construed Public Utilities Code section 728 to vest the commission with power to fix rates prospectively only. But we did not require that each and every act of

the commission operate solely in futuro; our decision was limited to the act of promulgating ‘general rates.’” (Id.)

Similarly, in this case we are not engaged in ratemaking as defined in the Edison case. Moreover, we make these changes to the balancing account procedures prospectively. Thus, the doctrine of retroactive ratemaking is inapplicable.

Our adopted procedures are not contrary to Pub. Util. Code § 792.5 because the procedures merely prohibit a utility from further augmenting its profits by recovering offsettable expenses that it already has adequate reserves to cover.

Finally, even though Pub. Util. Code § 455.2 requires certain water utilities to file general rate cases every three years unless otherwise agreed to by the Commission and utility, more frequent rate case filings may reduce but not eliminate the problem of these balancing account having unintended consequences. Only by modifying the balancing account procedures will we be able to directly address and remedy this problem.

### **3. Adopted Revised Procedures**

This section addresses the revised procedures that we implement for balancing account collection for the accounts existing on or after November 29, 2001. These procedures apply only to Class A water utilities because Class B, C, and D utilities use recorded earnings in their computations.

We address the following three scenarios: (1) districts that are within their rate case cycles and are not over earning; (2) districts that are within their rate case cycles and are over earning on an actual (recorded earnings) basis; and (3) districts that are outside of their rate case cycles. The following is an overview of the principles underlying the adopted procedures and a summary of the adopted procedures. The detailed procedures we adopt today are set forth in

Appendix A, and Appendix B provides an example of the application of these procedures.

**a) Principles Common to All Scenarios**

**(1) Offsettable Expense**

To qualify as an offsettable expense for balancing account treatment, the Commission must have approved the expense for balancing account tracking in a decision. A utility's advice letter requesting an offset rate increase should include a citation to the decision or other Commission document approving tracking of each type of expense requested, except for purchased power, purchased water and pump tax expenses.

The earnings data the utilities filed in response to the OIR indicated that almost half of the balancing account entries do not concern purchased power, purchased water or pump tax, and many contain multiple unexplained expense items (i.e., miscellaneous.) Thus, it is necessary for the utilities to better identify and justify the entries made in these balancing accounts.

**(2) Offset Revenues**

If the Commission authorized a change in base rates to offset the expense, the resulting offset revenues must be booked to the same balancing account. These revenues consist of the authorized incremental rate change multiplied by the recorded amount of water sold (for changes to the commodity charge) or by the number of meter equivalent customers (for changes to the service charge).

**(3) Tracking Offsettable Expense and Revenues in Balancing Accounts**

The earnings information the utilities provided in response to this OIR demonstrated that there is a lack of consistent tracking methods in the balancing accounts. We require that the utility book each authorized offsettable expense and corresponding offset revenue (if any) to its own balancing account. Each district of a multi-district utility shall keep its own set of balancing accounts. Balancing account balances existing after June 22, 1994, shall earn interest at the Commission-authorized rate.

**(4) Timing of Filings**

A utility shall seek to recover under and over collections in balancing accounts by filing an annual Advice Letter with the Commission's Water Division. The balancing accounts will be closed out every year.

Each utility's annual Advice Letter filing shall be filed by March 31 of the year following the year which is the subject of the request. The utilities' Advice Letter filings for November 29, 2001 through December 31, 2002 shall be filed no later than 90 days from the mailing date of this decision.

**(5) Means Test**

Two tests are available in order to determine if a utility is earning an amount greater than its authorized rate of return. The first is a pro forma or weather normalized means test which we described above. The Commission also uses this test to determine the utility's eligibility for a second year and attrition year increase in its general rate case cycle. The second test is the recorded rate of return means test, which uses actual, as opposed to weather normalized figures in the computation.

**b) Districts Within Their Rate Case Cycle That are not Over Earning**

If a district is within its rate case cycle and is not over earning, the problems associated with over earning do not exist. In this case, the utility shall recover its balancing account, subject to reasonableness review.

**c) Districts Either Within or Outside of Their Rate Case Cycle That are Over Earning**

If a utility is within its rate case cycle and is over earning, the utility's recovery of expenses from the balancing accounts will be reduced by the amount of the over earning, subject to reasonableness review. The utility shall remove the amount of the over earning from the balancing account and shall amortize it below the line.

The recorded rate of return means test shall be used to evaluate earnings for revenue received for all years. If a utility is outside of the rate case cycle but is not over earning according to the above tests, then it shall recover as set forth in Section V.B.5.b above. We anticipate that this scenario may occur if both the Commission and the utility agree to defer a utility's rate case filing pursuant to Pub. Util. Code § 455.2.

Although many utilities recommend that we use a pro forma, rather than a recorded earnings means test, we adopt the recorded earnings test because this test compares actual earnings with actual expenses. This is an appropriate comparison because actual dollars are paid out in a balancing account and actual dollars are over earned.

**VI. Comments to the Draft Decision**

The draft decision of Commissioner Brown was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure.



**VII. Assignment of Proceeding**

Geoffrey F. Brown is the Assigned Commissioner and Janet A. Econome is the assigned Administrative Law Judge in this proceeding.

**Findings of Fact**

1. Applying an earnings test to balancing accounts is not new.
2. The existing procedures for recovery of under and over collections in balancing accounts, which we suspended as of November 29, 2001, were originally established for the utilities to recover unanticipated increases in electricity costs between general rate cases, without the need to file an additional rate case application. The procedures also served the purpose of protecting shareholders from having to finance large unanticipated expenses until the next general rate case.
3. The procedures for recovery of under and over collections in balancing accounts served, in effect, as insurance to protect a utility against its failure to earn its authorized earnings due to unanticipated expenses beyond the utility's control.
4. The existing procedures become problematic when they have the effect of enhancing utilities' earnings above Commission-authorized rates of return.
5. Another related problem with the existing balancing account procedures occurs when a utility fails to file general rate case applications every three years, yet continues to seek balancing account treatment beyond the rate case cycle, thus depriving the Commission of scrutiny over the assumptions used to determine the rate structure. When these assumptions become stale, the rate structure becomes skewed.
6. While we anticipate that the problem of failing to file a general rate case application every three years will be addressed by Pub. Util. Code § 455.2(c)

requiring water utilities subject to the rate case plan to file rate cases every three years, that section permits the three-year filing requirement to be waived upon mutual agreement by the Commission and the water utility.

7. The original purpose of these balancing accounts was to allow the utilities to recover unanticipated expenses within the normal rate case cycle to prevent financial injury, and to serve as insurance to utilities that certain uncontrollable expenses would not affect their ability to achieve authorized earnings.

8. A utility that exceeds its authorized rate of return is not in financial peril.

9. The issue of how various risks affect a utility's rate of return involves an inquiry into all relevant circumstances, not just one specific factor.

10. One utility, CalAm, believed the existing balancing account procedure capped recovery at the utility's authorized rate of return, and operated its balancing accounts accordingly.

11. The revised procedures permit the utility to earn at least up to its authorized rate of return, and even more than the authorized rate of return through any means other than the collection of these balancing accounts.

### **Conclusions of Law**

1. We revise our procedures for recovery of balancing accounts existing on or after November 29, 2001 as follows: (a) if a utility is within its rate case cycle and is not over earning, the utility shall recover its balancing account subject to reasonableness review; and (b) if a utility is either within or outside of its rate case cycle and is over earning, the utility's recovery of expenses from the balancing accounts will be reduced by the amount of the over earning, again subject to reasonableness review. The utility shall remove the amount of the over earning from the balancing account and shall amortize it below the line. Utilities shall use the recorded rate of return means test to evaluate earnings for

all years. If a utility is outside of the rate case cycle but is not over earning according to the above tests, then it shall recover as set forth in part (a) of this conclusion of law.

2. We adopt the detailed procedures for Class A water and sewer utilities to dispose of balancing account balances accrued on or after November 29, 2001, as set forth in Appendix A, as well as the examples of the application of these procedures as set forth in Appendix B.

3. To qualify as an offsettable expense for balancing account treatment, the Commission must have approved the expense for balancing account tracking in a decision. A utility's advice letter requesting an offset rate increase should include a citation to the decision or other Commission document approving tracking of each type of expense requested, except for purchased power, purchased water, and pump tax expenses.

4. If the Commission authorized a change in base rates to offset the expense, the resulting offset revenues must be booked to the same balancing account.

5. Utilities should book each authorized offsettable expense and corresponding offset revenue (if any) to its own balancing account. Each district of a multi-district utility should keep its own set of balancing accounts. Balancing account balances existing after June 22, 1994 shall earn interest at the Commission-authorized rate.

6. A utility shall seek to recover under and over collections in balancing accounts by filing an annual Advice Letter with the Commission's Water Division. The balancing accounts will be closed out every year. Each utility's annual Advice Letter filing shall be filed by March 31 of the year following the year that is the subject of the request. The utilities' Advice Letter filings for

November 29, 2001 through December 31, 2002 shall be filed no later than 90 days from the mailing date of this decision.

7. D.02-12-055 affirmed the scoping memo in noting that the readjustment of a utility's specific rate of return is not within the scope of this industry-wide proceeding. The appropriate forum for such a utility-specific inquiry is a utility's general rate case or other appropriate proceeding the Commission may designate in the future.

8. The Commission has the discretion to modify the existing procedure when the procedure is producing unintended results.

9. The revised procedures we adopt do not constitute retroactive ratemaking. Moreover, we make these changes to the balancing account procedure prospectively.

10. Because we wish to achieve closure regarding the revisions to the balancing procedure for accounts existing on or after November 29, 2001, this interim order should be effective immediately.

### **FINAL ORDER**

#### **IT IS ORDERED** that:

1. We adopt the procedures for Class A water and sewer utilities to dispose of balancing account balances accrued on or after November 29, 2001, as set forth in the text of this decision as well as in Appendix A. We also adopt the examples of the application of these procedures as set forth in Appendix B.

2. This order is effective today.

This proceeding is closed.

Dated \_\_\_\_\_, at San Francisco, California.

## **APPENDIX A**

**PROCEDURE FOR CLASS A WATER AND SEWER UTILITIES TO PROCESS  
BALANCING-TYPE MEMORANDUM ACCOUNTS**

1. SCOPE

The purpose of this procedure is to describe how to properly process the balancing-type memorandum accounts established by Resolution W-4294, Ordering Paragraph 4 and subsequent “balancing” and memorandum accounts<sup>13</sup> (accounts). Each account will be analyzed for each calendar year from the last authorized amortization of the account.

2. ADVICE LETTER AND WORKPAPERS

On or before March 31 of each calendar year, submit the following:

- a. An Advice Letter requesting recovery of under collections or refund of over collections in all accounts. The format of the Advice Letter shall be as shown in Water Division Standard Practice U-27-W.
- b. Account calculations as illustrated in the June 1983 “Procedures for Maintaining Balancing Accounts for Water Utilities,”<sup>14</sup> Appendices 1, 2, and 3, adding annual totals to both the “Revenue” and “Expense” columns.<sup>15</sup> Please use the format in Appendix B.
- c. Rate of return calculations as described below. Please use the format in Appendix B.

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<sup>13</sup> While R.01-12-009 suspended only purchased power, purchased water and pump tax balancing accounts for Class A water utilities, this procedure will apply to all outstanding balancing and memorandum accounts.

<sup>14</sup> In accordance with Ordering Paragraph 1 of D.94-06-033, balancing and memorandum accounts shall accrue interest as of June 22, 1994. The rate to be applied is one-twelfth of the most recent month’s interest on Commercial Paper (prime, three months), published in the Federal Reserve Statistical Release (FRSR), Table G.13, or its successor publication. In later versions of FRSR, Table G. 13 (since 1997) and in its successor, Table H.15, the rate referred to as “non-financial” should be used.

<sup>15</sup> Changes in purchased power cost shall be calculated by recalculating the composite rate adopted in the last General Rate Case (GRC).

For each account submit the following:

- a. The Commission document authorizing the account.<sup>16</sup>
- b. A copy of the resolution or decision authorizing the last amortization of the account.

### 3. AMOUNT OF OVER EARNINGS

To determine disposition of the accounts it is necessary to determine whether the district over earned (i.e. exceeded the company's last authorized rate of return) in each calendar year. The authorized rate of return will be compared with the recorded rate of return in the following manner:

- a. The recorded rate of return will be calculated in the same way as illustrated in the May 1, 1995 "New Procedures for Filing Step Increase, Attrition and Offset Advice Letters." However, the revenue and expense components used in calculations of the recorded rate of return will be adjusted in the following manner:
  - 1) Calculate total recorded revenue excluding the individually identified total of (a) surcharge, (b) surcredit, and (c) offset rate changes tracked in the accounts (increases or decreases). Also identify any extraordinary sources of revenues (such as leased water rights) that are not typically received every year. Unless they were included as reasonable in the last GRC, exclude extraordinary items.
  - 2) Calculate total recorded allowable expenses minus the individually identified total of offset expense components. Also identify any extraordinary expenses (such as costs to repair storm damage) that are not typically experienced every year. Unless they were included as reasonable in the last GRC, exclude extraordinary items.
- b. If the recorded rate of return exceeds the authorized rate of return, then the district has over earned. The dollar amount of over earnings is calculated by multiplying the difference between the recorded rate of return and the authorized rate of return by the recorded weighted average rate base.

IF THERE HAS BEEN NO OVER EARNING IN ANY CALENDAR YEAR,  
PROCEED TO STEP NUMBER 5.

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<sup>16</sup> Because balancing accounts area created when the utility first requests an offset for the tracked expense, utilities that have never requested an offset do not have balancing account protection.

IF THERE HAS BEEN OVER EARNING IN ANY CALENDAR YEAR, PROCEED WITH THE ADJUSTMENT CALCULATION BELOW.

#### 4. ADJUSTMENT CALCULATION

Determine the account adjustment as follows:

- a. Sum all expense components from all accounts, excluding interest.
- b. Record, as the annual adjustment amount, either the sum of the expense components or the amount of over earning, whichever is less.
- c. In a separate account distribute 1/12 of the adjustment amount to the months of the calendar year in the same manner as if they were account revenues.
- d. Treat these monthly balances as if they had been booked to the account throughout the year and apply interest to the monthly accrual at the 90-day commercial paper rate reported for that month.<sup>17</sup>

#### 5. SURCHARGE OR REFUND

Combine the accruals from all accounts for the calendar year with any amount calculated in step 4 and dispose of as follows:

- a. Request recovery of a net under collection in the accounts by amortizing the under collection and applying a surcharge to the quantity rates. If the amount is less than 5% of the last authorized revenue requirement, recovery should occur in one year, for 5%-10% in two years and over 10% in three years.
- b. Request refunding of a net over collection to the customers by amortizing the over collection and crediting the service charge of all customers, based on the meter equivalent size of the service connection, for such period of time needed

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<sup>17</sup> Historic values for the commercial paper rate are obtained from the Federal Reserve's web site  
(<http://www.federalreserve.gov/releases/h15/data/m/cp3m.txt>).



to refund the amount of the over collection. Refunding shall occur as soon as reasonably possible.

## **APPENDIX B**

The most recent GRC of the Smallville district of Regulated Water Company (RWC) was in 2002, with test years of 2003 and 2004.

Smallville experienced an increase in power costs in March of 2003 and began tracking them in an account. Smallville was granted an offset rate increase in April of 2003. Subsequently, there were additional increases in power cost and additional offsets were approved.

Smallville experienced an increase in purchased water costs in July of 2004 and began tracking them in a separate account. It was granted an offset rate increase in September of 2004.

RWC filed Advice Letter 100 to recover the 2003 power costs in March of 2004.

### **Advice Letter 100**

#### 2003 Purchased Power

Month	Recorded Sales (KCcf)	Recorded Power Consumption (Kwh)	Incremental Expense Rate Change (\$/Kwh)	Incremental Revenue Rate Change (\$/Ccf)	Revenue Component (\$)	Expense Component (\$)	Over or (Under) Collection (\$)	Commercial Paper Rate (%)	Interest (\$)	Accrual (\$)
Jan	240.2	168,600	-	-	-	-	-	4.77	-	-
Feb	237.3	165,600	-	-	-	-	-	4.79	-	-
Mar	234.2	162,400	0.015	-	-	2,436	(2,436)	4.81	-	(2,436)
Apr	247.2	178,400	0.015	0.0111	2,744	2,676	68	4.79	(10)	(2,378)
May	328.6	231,000	0.015	0.0111	3,647	3,465	182	4.81	(10)	(2,205)
Jun	328.4	235,000	0.025	0.0111	3,645	5,875	(2,230)	4.98	(9)	(4,444)
Jul	349.3	242,200	0.025	0.0111	3,877	6,055	(2,178)	5.11	(19)	(6,640)
Aug	342.8	247,000	0.025	0.0193	6,616	6,175	441	5.25	(29)	(6,228)
Sep	333.2	231,100	0.030	0.0193	6,431	6,933	(502)	5.32	(28)	(6,758)
Oct	298.0	206,600	0.030	0.0193	5,751	6,198	(447)	5.88	(33)	(7,238)
Nov	247.3	180,000	0.030	0.0193	4,773	5,400	(627)	5.81	(35)	(7,900)
Dec	207.6	150,000	0.030	0.0193	4,007	4,500	(493)	5.87	(39)	(8,432)
Total Revenue Component					41,492					
Total Expense Comp						49,713				

Step 3.a&c: RWC determines that Smallville district had over earnings of \$36,000 in 2003.

Step 4.a: There is only the purchased power account, which has an expense component of \$49,713.

Step 4.b: The over earning amount is \$36,000, which is less than the total expense component of \$49,713. \$36,000 is recorded as the adjustment amount.

Step 4.c: In a new and separate account (p. 5), \$36,000/12 is booked to each month of 2003.

Month	Adjustment (\$)	Commercial Paper Rate (%)	Interest (\$)	Accrual (\$)
Jan-99	3,000	4.77	-	3,000
Feb-99	3,000	4.79	12	6,012
Mar-99	3,000	4.81	24	9,036
Apr-99	3,000	4.79	36	12,072
May-99	3,000	4.81	48	15,121
Jun-99	3,000	4.98	63	18,183
Jul-99	3,000	5.11	77	21,261
Aug-99	3,000	5.25	93	24,354
Sep-99	3,000	5.32	108	27,462
Oct-99	3,000	5.88	135	30,596
Nov-99	3,000	5.81	148	33,744
Dec-99	3,000	5.87	165	36,909

Step 4.d: Interest is applied to the monthly accruals in the adjustment account.

Step 5.: Combine the accruals:  $(\$8,432) + \$36,909 = \$28,477$ .

Step 5.b: The Advice Letter should request a surcredit be applied to the service charge until the amount in Step 5 is refunded.

## SUMMARY OF EARNINGS

Dollars in Thousands

	Decision 00-00-000	- 2003 Recorded	2003 Recorded with Adjustments
OPERATING REVENUES			
Metered Revenues	2,209.0	2,509.3	2,509.3
Fire Service	20.5	20.9	20.9
Other	6.2	6.0	6.0
<b>Adjustments:</b>			
<b>Purchased Power Surcharge</b>			-41.5
Memorandum Account Amortization			-128.3
Total	2,235.7	2,536.2	2,366.4
OPERATING EXPENSES			
Purchased Water	408.2	439.2	439.2
Purchased Power	319.1	331.2	331.2
Chemicals	15.2	16.3	16.3
Payroll	307.5	301.2	301.2
Uncollectibles	8.2	8.6	8.6
Other O&M	155.2	169.0	169.0
Other A&G, & Misc	231.8	237.6	237.6
<b>Adjustments:</b>			
<b>Pur Power Exp Component</b>			-49.7
Subtotal	1,445.2	1,486.6	1,436.9
General Office Allocation	206.5	212.5	212.5
Total O & M Expenses	1,651.7	1,699.1	1,649.4
Depreciation	161.2	168.9	168.9
Ad Valorem Taxes	42.5	43.0	43.0
Payroll Taxes	34.2	33.9	33.9
Other Taxes and Fees	21.3	22.5	22.5
Subtotal	259.2	268.3	268.3
Total Operating Expenses	1,910.9	1,967.4	1,917.7
Net Revenues Before Income Tax	324.8	568.8	448.7
State Income Tax	15.6	27.3	26.8
Federal Income Tax	100.7	176.3	173.1
Total Income Tax	116.3	203.6	199.9
NET OPERATING REVENUE	208.5	365.2	248.8
RATE BASE	2,342.7	2,392.0	2,392.0
RATE OF RETURN:			
Authorized	8.90%		
Recorded		15.27%	10.4%

Over earning is 10.4%-8.90%=1.5%. The dollar amount of over earning is  
 1.5% x \$2,392,000 = \$36,000.